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# Behind the economic failures of 2005; The outlook for 2006–2007

***With weak investment, dependence on external factors and lack of reform, the economic upswing in Ukraine that began in 2000 has been unsustainable. According to ICPS estimates, Ukraine's GDP grew 2.5% in 2005, not the 7% forecast at the beginning of the year. Over 2006–2007, Ukraine's economy will grow 5.5% per annum***

## 2005—the year of GDP growth slowed way down

Over the period of the economic upswing that began in Ukraine in 2000, 2005 has proved to be the year of slowest economic growth. According to ICPS estimates, GDP grew 2.5% in 2005. Despite continued rapid growth of consumption, investment in the country's economy shrank. This decline in investment was driven by deep cuts in public investment. The lack of public resources for capital investment was the result of the new Administration's socially-oriented policies.

According to ICPS estimates, the balance of trade fell to US $118mn in 2005, after a record-high US $4.9bn in 2004. In 2005, imports of goods grew almost as fast as during the previous year, whereas exports slowed down from 41.6% growth in 2004 to 6% in 2005. In August 2005, for the first time since 1999, the balance of trade in goods became negative. However, given the National Bank of Ukraine's high gold and currency reserves, this negative balance does not pose a threat to the country's macroeconomic stability at present. The main factor behind slow growth of exports was a drop in global prices for the steel products that are the main component of Ukrainian exports. Rapid growth of imports was primarily the result of rapid growth in disposable incomes.

Agriculture and the processing industries slowed down significantly. Slow growth in agriculture is the result of its high dependence on two crops, grain and potato, which causes indicators fluctuate wildly every year. Slow growth in processing industries was primarily the result of a decline in metalworking due to an unfavorable situation with prices on global markets and shrinking domestic oil refining after import duty for petroleum products was reduced and oil supplies to Ukrainian refineries shrank.

According to ICPS estimates, gross value-added in trade shrank 9% compared to 2004. ICPS economists say the key factor behind this decline was the collapse of shadow and fictitious brokering schemes in wholesale trade that accounted for a significant share of trade growth throughout 2003–2004.

Although the new government committed many mistakes that contributed little to the country's economic growth, ICPS economists do not think that the steep economic slowdown is mainly the result of failed policies in 2005. Instead, ICPS experts are convinced that the foundation for sustainable economic development was not laid during the previous years. According to ICPS economists, slower economic growth was the result of three long-term factors:

**Weak investment.** Average growth of gross fixed investment was 7.2% over 1998–2004. During this period, investment was mainly channeled to upgrade capacities from soviet times. The volume of investment in the creation of new companies and innovative technologies was minor. More than half of all capital investment involved company funds, which, given weak financial indicators for domestic businesses, could not be a sustainable, multi-year source of investment. As a rule, public investment was distributed opaquely and priority of government policy goals were not identified in advance. A low level of capitalization among domestic banks, limited access of foreign banks to the Ukrainian market, and high risks of bad debt hampered the development of commercial lending. A high level of corruption in the public sector, difficult access to the Ukrainian market, the lack of a transparent and level playing field for doing business scared foreign business away from investing in Ukraine.

**The lack of reforms.** Despite the urgent need for reforms and regular calls to reforms by various political forces, large-scale systemic transformations have not gotten going in Ukraine. Urgent reforms are needed in the social security system, the infrastructure sector (residential services, communications and transport) and the judiciary. Every year, delays in starting transformations in the social security system have resulted in inefficient use of public resources, while the government's inability to ensure appropriate social security has served as an excuse for taxpayers to avoid paying taxes in full. Ukraine's residential services sector

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continues to be unprofitable, while the refusal of consumers to pay for poor quality services has only deepened the crisis in this sector. Ukraine's backward provision of telecommunication services and its underdeveloped transport sector hinder commercial development and raise the costs of doing business. This, in turn, makes companies less competitive. The high level of corruption in the Ukrainian court system also raises the cost of doing business and hampers investment.

**Economic dependence on external factors**. Over the past five years, the country's economic upswing was largely the result of growing exports of metal products. This high dependence on exports and the dependence of these exports on one type of product made the Ukrainian economy hostage to the pricing situation on global markets. Indeed, when metal prices began to slip, the economy revealed its lack of preparedness. The prolonged economic boom relieved successive Governments of the need to look for new drivers of economic growth and to implement policies that would facilitate structural changes in the economy. The low price of gas and other fuels did little to provide incentives for company owners and managers to invest in upgrading technologies and led to the high gas exposure of Ukrainian economy. Steep gas price rises will make products manufactured by such companies uncompetitive.

## GDP should grow 5.5% annually over 2006–2007

The ICPS forecast for 2006–2007 is for the economy to grow 5.5% per annum. The acceleration in 2006 will be driven by renewed investment flows, which are expected to grow 7% according to the ICPS forecast on the back of increased commercial lending and public investment. In 2007, investment will accelerate to 9% per annum.

After a record-high growth throughout 2005, private consumption will slow down to 8% in 2006 and remain flat in 2007. The slowdown in household consumption will be because of slower growth in personal incomes.

As in 2005, imports will grow faster than exports throughout the forecast period. The value of trade in goods will climb 6% in 2006 and 7% in 2007, whereas imports will grow 11% per annum. The balance of trade will become negative in 2006; while the current account balance will grow negative in 2007.

According to the ICPS forecast, consumer prices will grow as fast in 2006 as they did in 2005, 11.5% per annum. In 2007, prices should slow down to 7%, as personal income growth slows. Producer prices will also grow more slowly. Provided there are no unpredictable fluctuations on external markets, the Producer Price Index will grow 6% in 2006 and 7% in 2007.

The share of GDP re-distributed through the Consolidated Budget will fall back to 29% over 2006–2007. As social benefits grow more slowly, Consolidated Budget expenditures will remain flat in 2006, at 32% of GDP, and then shrink to 31% of GDP in 2007. ICPS economists do not expect a significant decline in tax rates throughout the forecast period.

According to the ICPS forecast, interest rates for hryvnia loans will gradually fall closer to interest rates for hard currency loans. The average rate for hryvnia loans will shrink to 9% by late 2007.

### *Key macroeconomic indicators*

| Years | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|
| Indicators | estimate | | forecast | |
| GDP, *mn UAH* | 267.3 | 344.8 | 412.8 | 486.4 |
| GDP, rcc, % | 9.6 | 12.1 | 2.5 | 5.5 |
| Real industrial output, rcc, % | 15.8 | 12.5 | 3.0 | 6.5 |
| Real agricultural output, rcc, % | -11.0 | 19.9 | 2.0 | 1.0 |
| Gross investment, *% of GDP* | 22.0 | 19.1 | 20,3 | 19.6 |
| Real gross fixed investment, apc, % | 15.8 | 10.0 | 1.0 | 7.0 |
| Real consumption, apc, % | 12.8 | 12.1 | 13.8 | 7.3 |
| Net FDI, *mn USD* | 1,411 | 1,711 | 7,200 | 3,000 |
| Real disposable household income, apc, % | 9.1 | 16.8 | 20.5 | 6.0 |
| Real retail trade, apc, % | 20.5 | 21.9 | 22.0 | 9.0 |
| Consumer price index, apc, % | 8.2 | 12.3 | 11.5 | 11.5 |
| Producer price index, apc, % | 11.1 | 24.1 | 11.1 | 6.0 |
| Population, *mn* | 47.6 | 47.3 | 47.0 | 46.8 |
| Average monthly real wages, apc, % | 15.2 | 23.8 | 18.0 | 8.0 |
| Unemployment rate (ILO methodology), % | 9.1 | 8.6 | 8.2 | 8.0 |
| Exports of goods and services, apc, % | 24.0 | 41.6 | 6.0 | 6.0 |
| Imports of goods and services, apc, % | 28.7 | 26.0 | 23.0 | 11.0 |
| Current account balance, *% of GDP* | 5.8 | 10.5 | 2.9 | 0.9 |
| Consolidated Budget balance, *% of GDP* | -0.2 | -3.2 | -2.0 | -3.0 |
| Official exchange rate (average annual), *UAH/USD* | 5.33 | 5.32 | 5.12 | 5.05 |

*apc = annual percentage change*
*rcc = real cumulative change*

Sources: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by ***quarterly predictions***

## Forecast risks

The ICPS forecast could prove overly optimistic under these five circumstances:

- significant price hikes for Russian gas coupled with a full-scale trade war with Russia that will include removing goods from the free trade regime, a growing number of anti-dumping investigations against Ukrainian exports, and restrictive import quotas;
- further price declines for Ukrainian export commodities on external markets;
- low tax receipts as business performance falls off;
- the inability of a pro-government party to ensure coalitional majority in the Verkhovna Rada, which would make it difficult to adopt key government decisions;
- the NBU switching to a more flexible exchange rate, which could significantly influence hryvnia and foreign currency rates. ■

*For more about ICPS economic forecasts, you can contact Yevhenia Akhtyrko, our senior economist, by phone at (380-44) 484-4403 or via e-mail at eakhtyrko@icps.kiev.ua.*

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To be included in the distribution list, mail your request to: marketing@icps.kiev.ua.
***icps newsletter*** editor: Yevhen Shulha (shulha@icps.kiev.ua)
Phone: (380-44) 484-4400. Fax: (380-44) 484-4402.
English text editor: L.A. Wolanskyj
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Address: vul. Pymonenka 13A, Kyiv, Ukraine 04050
Web-site: *http://www.icps.com.ua/eng/*